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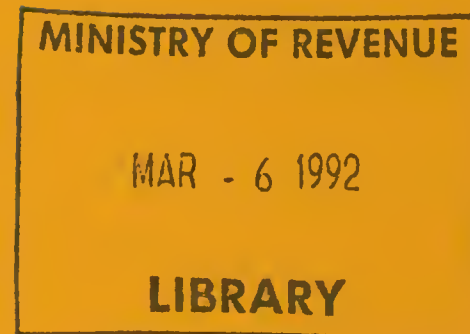
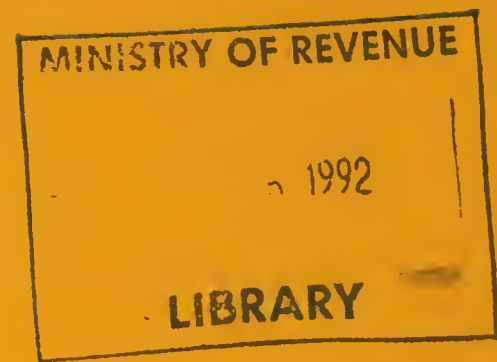
**The Federal-Provincial Tax
Collection Agreement: How
Ontario Receives Its Personal
Income Tax**

ASPECTS OF PERSONAL INCOME TAXATION IN ONTARIO

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**Ministry
of
Revenue**



In 1991-92, the Ontario Ministry of Revenue reviewed several aspects of personal income taxation in Ontario. The review is comprised of six essays. They are:

1. Ontario PIT Administration by Revenue Canada, Taxation
2. The Federal-Provincial Tax Collection Agreement: How Ontario Receives Its Personal Income Tax
3. Personal Income Tax Coordination - The Federal-Provincial Tax Collection Agreements: An Analysis of the Finance Canada Discussion Paper
4. Changing Federal-Provincial Partnerships: A Comparison of the Terms and Provisions of the Canada-Quebec GST Agreement and the Federal-Provincial Tax Collection Agreement
5. Rationalizing the Personal Tax and Transfer Payment Systems: The Quebec Experience and Prospects for Ontario
6. A Compromise Solution: An Alternative to the Present Federal-Provincial Tax Collection Agreement and Establishment of a Separate Ontario PIT Administration

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Introduction

Since 1962, all provinces except Quebec, have had their provincial personal income taxes collected on their behalf by the federal government under the terms and conditions of the Tax Collection Agreement. Under the Agreement, provinces receive charge-free processing, collection, audit, prosecution and remittance service from the federal government. The federal government, in turn, is provided with a uniform personal income tax system across Canada that conforms to federal statutes, regulations and interpretations. With the introduction of provincial tax credit schemes, the federal government has accommodated their administration on behalf of the provinces. Provinces pay a fee based on the amount of provincial credits processed.

Over time, this *quid pro quo* arrangement has had its supporters and detractors. Changing regional needs have challenged the extent to which the Agreement's requirements for uniformity satisfy the unique needs of the provinces.

This paper provides a brief description of the developments leading to the Tax Collection Agreement, followed by an examination of its provisions and their implications for Ontario. The paper is not intended to be an evaluation of the Agreement.

It is, however, intended to provide some insight into the working mechanics of the Agreement and the advantages and disadvantages for the federal and provincial governments. Readers may draw their own conclusions.

Historical Backdrop

Administration and collection of Ontario personal income tax (PIT) has had an interesting history. For 50 years following Confederation, municipalities collected the tax, and except for a 5-year period, during which no tax was collected, it has been collected by the federal government.

Both federal and provincial governments have taxing powers under the British North America (BNA) Act. Provincial powers are restricted to fields of direct taxation. During the years immediately following Confederation, provincial revenues consisted mainly of federal subsidies. It was not until the depression of the late 19th century when provinces entered the direct taxation field for the first time.

During World War I, the federal government began to tax in the same fields as the provinces, resulting in a tax jungle for all concerned. The Rowell-Sirois Report of 1940 recommended that an extra-constitutional agreement was necessary to restore order. The result was the establishment of Tax Rental Agreements, whereby the federal government provided the provinces with a fixed percentage of federal tax revenues collected. In exchange, the provinces agreed to absent themselves from direct taxation in the personal income tax field.

While most provinces signed the Tax Rental Agreements, Quebec was never a partner, and Ontario, which continued to receive federal subsidies, opted in only in 1954. Both provinces were suspicious of the federal offer, the acceptance of which conferred control to the federal level and the amount of which was felt to be lower than justified by the provincial population base.

Growing dissatisfaction with the Tax Rental Agreements led to the Tax Sharing Agreements of 1957. Under this arrangement, the provinces gained a share of revenues in the fields of corporate tax and succession duty revenues, as well as an increase in the percentage of personal income taxes. Formulae for equalization and stabilization payments were also established.

At the 1960 federal-provincial conference, provinces began to demand a “fairer share” of federal tax revenues. Recognizing the mounting pressure from the provinces, the federal government announced that as of March 31, 1962, it was discontinuing the Tax Sharing Agreements. In their place, Tax Collection Agreements were introduced. Via these agreements, all provinces, except Quebec, have their personal income taxes collected on their behalf by the federal government.¹ Ontario’s Agreement was signed April 24, 1962.

1. On behalf of the federal government, Finance Canada is responsible for the Tax Collection Agreement. At the same time, collection of Ontario's personal income tax (PIT) is administered by Revenue Canada, Taxation (RCT). For a detailed description of the structure and processes of RCT's system of administering PIT, refer to the essay entitled **Ontario PIT Administration by Revenue Canada, Taxation**.

PART 1

HOW THE AGREEMENT WORKS

Introduction

The Agreements recognize the constitutional right of both levels of government to levy taxes in the same tax fields, while empowering the federal government to be the national collector of personal income tax. Provincial taxes are derived by the provinces setting their own tax rates as a percentage of “basic federal tax”.

Since the Agreements were signed in 1962, most provincial governments, Ontario included, have introduced tax credit schemes. These schemes are administered via the personal income tax system by the federal government on behalf of the provinces.

In Ontario, tax credits comprise the property and sales tax credits, the political contribution tax credit, and most recently, the Ontario Home Ownership Plan (OHOSP) tax credit. The province pays a fee to the federal government for the administration of its tax credits via the federal income tax return. The fee is charged at a rate currently equivalent to 1% of total provincial credits processed. This amounts to about \$4 million annually.

The Benefits

Like any contract, both parties agree to “give” something to the other in order to gain a desired benefit. In general terms, the provinces gain a charge-free service. In exchange, the federal government is granted a measure of regulatory authority that ensures provincial conformity with federal statutes, regulations and interpretations.

The chart below illustrates the nature of benefits “exchanged “ under the Agreement.

Provincial Benefits	Federal Benefits
<ul style="list-style-type: none">• charge-free processing, audit, collection, and prosecution• provincial tax amounts are based on tax assessed, whether collected or not (i.e. the province never has “bad debts”)• cost-reduced processing of provincial tax credit schemes	<ul style="list-style-type: none">• provincial acts and administration must conform to federal statutes, regulations and interpretations• retention of fines, arrears interest on overdue taxes, and penalties, on both federal and provincial tax amounts• 1% fee based on value of credits processed

Restrictions on the Provinces¹

The authority granted to the federal government by the Agreement, while ensuring federal-provincial conformity, restricts the autonomy of provinces in **four** basic areas.

1. Provinces must receive federal approval before introducing any tax credit scheme which would induce investment income or preference that discriminates with respect to the jurisdiction location of the investment. For example, Ontario could not unilaterally use the personal income system to encourage investment in Ontario-based companies to the exclusion of companies in other provinces.²
 2. Provincial tax legislation must accept the same base as defined under the federal Income Tax Act. Provincial tax is based on a single rate percentage of "basic federal tax", the calculation of which is determined entirely by federal definitions of amounts and types of income and amounts and types of allowable deductions. Similarly, the amount and definition of federal non-refundable tax credits must be accepted by the provinces.
 3. Provinces agree that provincial legislation and regulations will be kept in a form similar to the federal Act and regulations.
 4. The provinces covenant that they will not impose income tax on:
 - employees of another country, members of the family and servants of employees of another country;
 - municipal authorities, municipal or provincial corporations, registered charities;
 - non-resident-owned investment corporations;
 - corporations issuing qualifying shares, deferred profit sharing plans or certain property acquired in trust governed by deferred income plans, which may give rise to a refundable tax; or
 - non-residents: e.g. provinces do not share in any tax levied on non-residents, nor in certain investment income earned by non-residents from real property situated in the province.
1. In the 1991 Federal Budget tabled on February 26, 1991, the Finance Minister indicated that the federal government is prepared to consider requests from the provinces for revisions to the Tax Collection Agreement which would provide greater flexibility. Mentioned specifically was the potential for provinces to levy the provincial tax rate against taxable income rather than Basic Federal Tax. A federal discussion paper was released on June 25, 1991. A four-member advisory committee, chaired by Robert Brown, Chairman of Price Waterhouse of Toronto, has been commissioned to review technical aspects of the paper, conduct public consultations, and report back to the federal Finance Minister by October 1, 1991.
 2. The Ontario government has announced its intention to establish the Ontario Ownership and Worker Investment Plan, a program which provides for federal and Ontario tax credits for employees investing in their Ontario-based companies. This program is being implemented via the federal Labour Sponsored Venture Capital Corporation (LSVCC) framework. Other provinces have also established LSVCC programs in concert with the federal government.

Changes in Rates of Provincial Tax

There are several stipulations regarding provincial rate changes. They are:

- a change in the rate of provincial tax is effective January 1st in any year and must be expressed in increases of one or more half-percentage points;
- Ontario must notify the Minister of National Revenue, in writing, of the change by October 15th of the preceding year for collection beginning January 1st, or by April 15th for collection beginning July 1st of the same year; and
- where changes at the federal level would result in a reduction of the total provincial tax revenue of at least 1% due to the federal change, the province may increase its tax rate to the nearest whole percentage point required to receive the same total provincial revenue had the federal change not been made.

Illustration

Ontario tax rate	50%
Total Ontario revenue	\$ 10.0 billion
Total Ontario revenue after effect of federal changes	\$ 9.8 billion
Loss of Ontario revenue	\$ 0.2 billion (2%)

To generate the same amount of tax, the Agreement allows the Ontario rate to rise by the **nearest whole percentage point**.

New Ontario tax rate	51%
Total Ontario revenue	\$ 9.996 billion

Administration and Collection

Since the federal government is the collector of Ontario personal income tax, federal authorities must be empowered to act on Ontario's behalf.

- The Minister of National Revenue and designated officials are empowered by Ontario with all requisite authority;
- Ontario must accept as final all decisions of the Minister of National Revenue;
- any necessary actions, suits, prosecutions or other legal proceedings shall be taken by Canada on behalf of Ontario; and
- payment by a taxpayer will be applied first to tax payable to Ontario and secondly to tax payable to the federal government. In addition, provinces are guaranteed the amount of provincial tax assessed, whether collected or not.

Illustration

A taxpayer's federal-provincial liability is as follows:

Basic federal tax (BFT)	\$ 10,000
Ontario tax (50% of BFT)	\$ 5,000
 Total	 \$ 15,000
 Tax deducted from pay cheques	 \$ 13,000
Tax owing (\$15,000 - \$13,000)	\$ 2,000

Since tax is applied first to Ontario (\$5,000), the \$2,000 outstanding is a debt owing to the federal government only. Even if the taxpayer paid less than \$5,000 in income tax, Ontario would receive the full \$5,000.

Disputes and Differences

Both parties have right of access to the courts as a means of resolving disputes and differences if:

- either party feels that the other has failed to observe a provision of the Agreement; or
- there is a disagreement as to interpretation of any of its provisions.

The stipulated process is as follows:

- within 60 days written notice of the dispute, the province refers the matter via the Lieutenant Governor to the Court of Appeal of Ontario;
- the Court is asked to rule on the matter and outline the steps to be taken for the parties to restore mutual compliance with the Agreement;
- the steps determined by the Court of Appeal of Ontario (or by the Supreme Court of Canada, should the action prescribed by the provincial court be appealed) are binding on both parties;
- failure to comply with the prescribed court action is considered cause for the other party to terminate the Agreement.

Each party agrees to accept and bear its own costs of the action.

Termination of the Agreement

The Agreement is operative on a yearly basis from January 1st each year to December 31st of the same year. Termination of the Agreement, except for violations as previously outlined, may be accomplished by:

- Canada, by written notice from the Minister of Finance to the Treasurer of Ontario at **any time during the year**, effective January 1st of the following year;
- Ontario, by written notice of the Treasurer of Ontario to the Minister of Finance (Canada) by **October 1st of the year**, effective January 1st of the following year.

The terms of the Agreement continue to apply to the years during which the Agreement was operative. For example, assume the Agreement were to be terminated effective January 1, 1992. The terms of the Agreement would continue to apply to all taxation years ending December 31, 1991, even though related actions would extend well beyond January 1, 1992.

PART II

THE PAYMENT SCHEDULE: A MULTI-YEAR CYCLE

Introduction

The payment schedule has been one of the main points of discussion during the life of the Agreement. The number, timing, and amount of the payments has been a source of ongoing, and at times contentious, dialogue between Ontario and the federal government. Understanding the mechanics of the payment schedule and payment amounts are complicated by several factors:

- The methodology of generating federal estimates of provincial income tax due to a province for a given taxation year;
- a given taxation year runs from January 1st of a year to December 31st of the same year; and
- the payments for a given taxation year cross three fiscal years, which run from April 1st to March 31st of the following year.

Federal Estimates

The amount of provincial personal income tax due to a province is forecast by the federal Department of Finance. In February of the taxation year, from its internally-developed economic model, Finance Canada produces a forecast of gross Basic Federal Tax (BFT) anticipated Canada-wide for the taxation year. Based on data from the last complete taxation year (the taxation year two years previous) the percentage of Canada-wide BFT attributable to Ontario is calculated. To this forecast, three adjustments are made.

First, an addition is made to the gross forecast to more closely approximate estimated BFT assessments for prior taxation years. Second, a reduction is made in estimated BFT attributed to Canadian residents abroad, who would have a federal, but no provincial, tax liability. Third, estimated tax revenue effects of federal budget changes are quantified at the national and provincial levels.

In July/August and November/December of the taxation year, revised estimates are made based on updated economic data received since the initial estimate made in February. In addition, the forecast of gross Canada-wide and province-specific BFT revenues are revised. In the July/August period, revised BFT estimates are based on BFT data for the last complete taxation year (the taxation year two years previous) as of the end of February of the current taxation year, rather than the end of December of the previous taxation year. In the November/December forecast, the BFT data used are based on the immediately preceding taxation year as of October 15 of the current taxation year.

To calculate provincial personal income tax amounts, two variables are used - estimated BFT to be derived from the province and the provincial rate of tax as a percentage of BFT. For example, if the BFT of an Ontario taxpayer were \$10,000 and the Ontario tax rate were 50%, Ontario personal income tax would be \$5,000 ($\$10,000 \times 50\%$).

Finally, adjustments are made in provincial income tax due to Ontario based on:

- reductions for the Ontario Tax Reduction and Ontario Tax Credit (OTC) programs; and
- additions for Ontario surtax.

For a detailed review of the process of federal estimates and payment calculations, using the 1991 taxation year, see Appendix A.

Tax Remittances and the Taxation Year

Beginning in January each year, employees have income tax deducted from their pay cheques by their employers and remitted to Revenue Canada, Taxation (RCT). The amount of deductions, known as source withholding deductions, are based on:

- the estimated federal income tax payable in relation to estimated annual income and employees TD1 (deduction and non-refundable tax credit) returns on file; and
- the estimated provincial income tax payable by the individual based on:
 1. the provincial tax rate as a percentage of BFT; and
 2. the estimated annual income of the taxpayer.

Tax returns must be filed by individuals by April 30th following the end of the taxation year. For example, federal tax returns for the 1991 taxation year must be filed with RCT by April 30, 1992. The self-employed report their income for the fiscal period (business year) ending in the calendar year. A fiscal period is usually 12 months long; once a taxpayer chooses a date for the end of the first fiscal period for the business, subsequent fiscal periods must end on the same date each year. This date cannot be changed without the written permission of RCT, which will not be granted if one of the main reasons for the change is to avoid tax. In view of the maximum deferral of the payment of tax thereby afforded, many individuals choose January 31st as the end of their first fiscal year.

Other individuals, who do not have income tax deducted at source, must file and declare their tax liability by the April 30th deadline.¹

Provincial tax liability is determined by a taxpayer's province of residence as at December 31st, the last day of the taxation year, as declared in the annual income tax return. As returns are not due until April 30th of the following year, the ultimate recipient province of provincial taxes collected during the year is not known with certainty.

1. For a more detailed description of the process of source deductions and individual instalments, refer to the essay entitled *Ontario PIT Administration* by Revenue Canada, Taxation.

Illustration

Taxpayer X lived and worked in Ontario from January 1st to December 7th, 1990. On December 8, 1990 he moved, took up residency and began to work in Alberta. Upon filing the federal tax return for the 1990 taxation year, taxpayer X declares his province of residence on December 31, 1990 to be Alberta.

The entire amount of taxpayer X's provincial tax liability, as determined by the criteria previously described, goes to Alberta for the 1990 taxation year. Any excess of tax collected at source at Ontario rates over Alberta tax assessed would be refunded to taxpayer X. Although most of his income for 1990 had an Ontario source, Ontario would receive nothing; this would be so even if taxpayer X had zero Alberta-source income in 1990.

For the 1991 taxation year, employers began deducting and remitting income tax to RCT for employees on or before January 10, 1991. Ontario began to receive instalment payments from Finance Canada for the 1991 taxation year on February 20, 1991. This represents a time lag of 41 calendar days between first receipt of provincial income tax remittances by the federal government and transfer of same to Ontario.

Unapplied Taxes

In order for the federal government to determine which province should receive all, or a portion of, the provincial income tax deducted by employers, taxpayers must file federal tax returns. This allows the federal tax return to be matched to the tax withheld and remitted on behalf of the taxpayer.

In cases where a federal tax return is not filed, no match can be made. Since the taxpayer's province of residence on December 31st of the taxation year remains undeclared, provincial income tax deducted by the employer and remitted to RCT cannot be applied, with certainty, to any province.

Finance Canada estimates a total amount for Canada of unapplied taxes received from the provinces. Based on the provincial percentage of all provincial income taxes to be collected in that year, each province is allocated its proportionate share of unapplied provincial income taxes. The federal government includes the estimated amount of unapplied taxes when calculating the amount to be transferred to a province as part of the instalment payment schedule.

Ontario Tax Credits - Administrative Fees

As mentioned earlier, Ontario pays the federal government a fee for processing applications for Ontario Tax Credits within the personal income tax system. These credits provide:

- property and sales tax relief for low and modest income taxpayers;
- tax credits for eligible taxpayers who participate in the Ontario Home Ownership Savings Plan (OHOSP); and
- tax credits for political contributions.

The fee is charged at a rate currently equivalent to 1% of total provincial credits processed and is deducted from the personal income tax transferred to Ontario as part of the final adjustment for a given taxation year. For the 1991 taxation year, for example, the fee will be factored into the adjustment made in March 1993.

Instalment Payments

The total number of payments for a given taxation year consists of:

- 48 income tax instalment payments to Ontario;
- 24 Ontario tax credit instalment “payments” by Ontario to Canada; and
- 2 adjustments (interim and final) which reconcile the amount payable with the amount actually paid to and by Ontario.

For a detailed examination of the calculation of the federal estimates and instalment payments using actual figures for taxation year 1990, see Appendix B.

Payment Schedule for 1991 Taxation Year

For the 1991 taxation year, below is the payment schedule, including:

- income tax instalment payments from Canada to Ontario;
- Ontario tax credit “payments” from Ontario to Canada; and
- interim and final adjustments for provincial income tax due and Ontario Tax Credit payment and processing fee.

Month/Year	Income Tax Instalments	Ontario Tax ¹ Credit Payments	Adjustment Payments
Feb/91 ²	3	0	0
Mar/91 ³	4	0	0
Apr/91	4	4	0
May/91	4	4	0
Jun/91	4	4	0
Jul/91	4	4	0
Aug/91	4 ⁴	4	0
Sep/91	4	4	0
Oct/91	4	0	0
Nov/91	4 ⁵	0	0
Dec/91	4	0	0
Jan/92	4	0	0
Feb/92	1	0	0
Jan/93	0	0	1 ⁶
Mar/93	0	0 ⁷	1 ⁷
Totals	48	24	2

1. Based on estimated OTC data for taxation year 1990 supplied by Ontario Ministry of Treasury and Economics to Finance Canada in Feb. 1991.
2. Payment amounts based on first federal estimate made in Feb. 1991. For a detailed explanation of how the estimate is made, refer to Appendix A.
3. Final adjustments for 1989 taxation year completed.
4. Based on a second federal estimate of total 1991 provincial income tax, using assessed 1989 taxation year data as at Feb. 28, 1991 and a revised economic forecast by Finance Canada. The payment amounts are revised accordingly. If the revised federal estimate is higher than the original estimate, the remaining payment amounts are increased. If the revised federal estimate is lower than the original estimate, the remaining payment amounts are reduced (when this situation arose in fiscal year 1984/85, the overpayment amounts were recovered in equal portions from the last three payments of fiscal year 1984/85 and the first four payments of fiscal year 1985/86).
5. Payment amounts are adjusted again based on assessed 1990 taxation year data as at Oct. 15, 1991 and a revised economic outlook prepared by Finance Canada.
6. The total amount of provincial income tax by instalment payments is compared with the total amount due to the province based on assessed 1991 taxation year data as at Oct. 15, 1992. Any balance due to the province is paid as an “interim adjustment”. Any amount owing by the province is withheld from future payments (when this situation arose in fiscal year 1984/85, the overpayment amounts were recovered in equal portions from the last three payments of fiscal year 1984/85 and the first four payments of fiscal year 1985/86).
7. The total amount of provincial income tax paid by instalments and by “interim adjustment” is compared to the total amount due to the province based on assessed 1991 taxation year data as at Dec. 31, 1992. The same comparison is made for the total Ontario tax credits paid in comparison with the sum of the 24 tax credit payments and the federal fee for processing Ontario tax credits. Any balance owing is paid to the province as a “final determination”. Any amount owing by the province is withheld from future payments (when this situation arose in fiscal year 1984/85, the overpayment amounts were recovered in equal portions from the last three payments of fiscal year 1984/85 and the first four payments of fiscal year 1985/86).

Payment Schedule for 1991 Taxation Year by Fiscal Year

Due to the extended period of instalment payments, the schedule involves payments during three fiscal years. Below is a chart showing the number of payments by fiscal year.

Fiscal Year	Income Tax Instalments	Ontario Tax Credit Charges	Adjustment Payments
1990/91	7	0	0
1991/92	41	24	0
1992/93	0	See Note	2
Totals	48	24	2

Note: The total amount of tax credits is finalized during the calculation of the final adjustment made in March 1993, which is based on assessed 1991 taxation year data as at Dec. 31, 1992. Adjustments to the total payable are compared to the sum of the 24 payments, with the difference factored into the final adjustment.

For a detailed view of the payment schedule for 1991, as well as the overlapping relationships between taxation years and fiscal years for taxation years 1988, 1989 and 1990, see the chart in Appendix C.

PART III

IMPLICATIONS FOR ONTARIO

Introduction

As with all contracts, while both parties receive desired benefits from the arrangement, so must they both give something to the other. On the surface the “give and take” exchange would appear to be entirely related to money.

While this is true to a great extent, a closer perusal reveals that there are other important factors to be considered. This section of the paper highlights some of financial implications of the Agreement as well as other non-financial considerations.

The assessment begins with a summary overview of federal-provincial advantages and disadvantages, then continues with implications for Ontario.

Federal Perspective

Advantages

- 1. Ensures tax harmony at the federal-provincial level.
- 2. Reflects a spirit of federal-provincial fiscal co-operation.
- 3. Gives federal government a large measure of control over the tax policy of the provinces.

Disadvantages

- 1. Places the federal government in role as THE tax collector.
- 2. May be more costly to administer than separate provincial PIT systems.
- 3. Requires accommodation of a myriad of provincial tax credit schemes, which increase costs and complexity.

Ontario Perspective

Advantages

- 1. Is perceived as charge-free, except for fee for tax credit administration.
- 2. Reflects federal-provincial fiscal co-operation and tax harmony.

Disadvantages

1. Restricts Ontario's ability to use the PIT system as a means of:
 - vertical equity (ability to pay), other than via surtax, tax reductions, or tax credits;
 - income testing social benefits, other than via tax credits; or
 - inducing investment by way of economic incentive, other than via tax credits.
2. Commits Ontario to use “basic federal tax” as the amount upon which provincial PIT is calculated.¹ Any change in federal tax policy which results in a reduction of basic federal tax, automatically reduces Ontario personal income tax.

For example, basic federal tax is calculated after exemptions for:

- i) \$100,000 lifetime capital gains exemption ;
- ii) federal dividend tax credit;
- iii) exploration and development expenses;
- iv) Canadian motion picture film and video tape expenses; and
- v) other allowable personal exemptions and expenses.

Ontario may not deviate from the calculation of basic federal tax, even if it were opposed to some personal exemptions or allowable deductions, or wished to apply different tax rates to different types of income.

3. Gives federal government authority to refuse proposed provincial changes in existing provisions or introduction of new ones, such as variable rates of non-refundable tax credits.
 4. Ontario must pattern the federal Act and regulations, an obligation which requires regular amendments to the Income Tax Act (Ontario) following changes to the Income Tax Act (Canada) related to federal tax policy changes in federal budgets.
 5. Ontario's cash flow is adversely affected by the payment schedule and Ontario loses interest income both as a result of the payment schedule and as a result of deferred adjustment payments when revenue estimates are revised in Ontario's favour.
 6. Using “basic federal tax” may give Ontario taxpayers the impression that Ontario has a higher tax rate than Canada. (Ontario's tax rate is 53% of “basic federal tax” vs Canada's rates of 17%, 26% and 29% of taxable income.)
1. In the 1991 Federal Budget tabled on February 26, 1991, the Finance Minister indicated that the federal government is prepared to consider requests from the provinces for revisions to the Tax Collection Agreement which would provide greater flexibility. Mentioned specifically was the potential for provinces to levy the provincial tax rate against taxable income rather than Basic Federal Tax. A federal discussion paper was released on June 25, 1991. A four-member advisory committee, chaired by Robert Brown, Chairman of Price Waterhouse of Toronto, has been commissioned to review technical aspects of the paper, conduct public consultations, and report back to the federal Finance Minister by October 1, 1991.

Amendments to the Tax Collection Agreement

Since its inception in 1962, the Agreement has undergone many amendments. Most of the changes were technical in nature, resulting from revised wording or re-numbering of sections, clauses, etc. in the Income Tax Act, Canada or corresponding cross-references with the Income Tax Act, Ontario.

A number of the amendments have made substantive changes in the provisions of the Agreement. On balance, while both levels of government have benefited from the changes, the major benefits have been received by the federal government.

Ontario's benefits have been concentrated in changes occurring in 1976, 1978 and 1989. All of these changes related to improved or accelerated cash flow of instalment payments to the province.

Regarding federal benefits, most changes resulted in more control or authority for the federal government in the determination of estimates of provincial personal income tax revenues and in retention of all fines and penalties as well as awards from judicial proceedings.

For a chronology of changes in the Agreement, see Appendix D. For a discussion of how the federal government has maintained its advantage in the frequency and timing of instalment payments to Ontario, see **Delays Between Tax Remittances and Transfers to Ontario** on page 25 and Appendix E.

Financial Considerations

One of the most apparent attractions for Ontario, at first glance, is the financial advantage of the federal government absorbing all costs of administration. Except for the 1% fee for administration of Ontario tax credits, Ontario receives a “free” service.

While the federal government pays for the cost of administration, the Agreement also awards to the federal government:

- all interest that accrues on taxes in arrears;
- all penalties imposed on delinquent taxpayers; and
- fines or amounts awarded in judicial proceedings.¹

These additional, non-tax revenues, apply to both the **federal and provincial** portions of the tax in question. To determine the true costs of federal administration of the Ontario component of the personal income tax system, offsets from gross costs must be factored into the analysis.

Federal Actions to Increase Non-Tax Revenues

Since the commencement of the Tax Collection Agreement, the federal government has implemented a series of actions designed to increase their exclusive ancillary revenue from personal income taxes.

These actions include changes in interest rates, changes in interest rate computations, and earlier and more frequent tax remittances from employers. In addition, amounts awarded by way of fines and successful prosecutions have been increased. During the last few years, and as re-inforced by recent statements by the federal Finance Minister, the powers of Revenue Canada Taxation will be augmented to strengthen its collection authority. For a list of federal actions taken, see Appendix E.

1. While the Agreement makes such a provision (except for penalties under the Ontario Act related to provisions corresponding to section 163 of the federal act), provincial practice has been different. Judicial proceedings conducted by federal officials relate to amounts of federal tax only. Based on legal jurisprudence, the authority contained in the Income Tax Act (Canada) relates to federal income tax only. Although provinces could assign the power to federal authorities for prosecution of provincial personal income tax cases, due to administrative complexities associated with co-ordinating and determining the appropriate divisions of Court designated to hear various offences, no province has chosen to do so. Consequently, fines or amounts awarded are based on federal personal income tax only.

Amounts of Ancillary Non-Tax Revenue and Write-Offs

To determine the annual amount of ancillary non-tax revenue received, Revenue Canada, Taxation was asked to provide estimates of annual amounts received for arrears interest on overdue taxes, fines, penalties and to identify write-offs (bad debts).

Based on the information provided by Revenue Canada, Taxation, the chart below displays the amounts of non-tax revenue attributable to Ontario for the 1989-90 fiscal year, the latest year available as provided by Revenue Canada, Taxation.

ANCILLARY NON-TAX REVENUE ATTRIBUTABLE TO ONTARIO ¹			
(\$ 000's)			
Penalties and Interest		Write-offs	Total
133,207.34	—	26,331.95	106,875.39

1. For an explanation of how these amounts were calculated, refer to **Appendix G: Calculation of Non-Tax Revenue Attributable to Ontario**

Federal Estimate of Administrative Costs of Ontario PIT Component

Revenue Canada, Taxation (RCT) was also asked to provide an estimate of the cost of the Ontario component of the personal income tax (PIT) system. Using the percentage of Canadian taxfilers from Ontario (37.6% for taxation year 1988, the latest taxation year for which statistics are available), Ontario asked whether a similar percentage of national RCT expenditures would be attributable to Ontario operations.

The RCT response asserted that it was not possible for a province-specific allocation of expenditures to be calculated. However, RCT did reply as follows:

To test whether the taxpayer population ratio is an accurate measure of resources consumed in the administration of the PIT system in Ontario, we examined data on actual resource utilization in Ontario relative to returns processed in Ontario since 1984-85. Briefly, the comparison reveals that approximately 38-39% of the T1 returns processed were from Ontario while the Department spent a smaller proportion of its p-y's (*ed. note: p-y = person-years*) (about 25%) and expenditures (21%) in processing those T1s.

Applying the expenditure percentage of 21% against the 1989-90 national RCT budget expenditure estimate of **\$978.3 million**, produces an Ontario PIT administration cost of **\$205.45 million**. This figure, however, is comprised to a large extent of increased costs of administration associated with federal taxation initiatives.

As an additional part of the information requested from RCT, the Ministry of Revenue asked for a separate accounting of costs associated with various tax changes contained in federal and provincial budgets from 1971 to 1990, inclusive. For the full list of items, see **Appendix F - Review of Tax Changes in Federal and Provincial Budgets 1971 - 1990**.

The RCT response indicated that a separate accounting of the cost of federal and provincial tax changes was not possible. While specific costs are not available, a brief perusal of the contents of Appendix F reveals that the more elaborate items, particularly those requiring extensive computer systems changes, relate to federal tax policy initiatives. For example, the introduction of the federal refundable child tax credit in 1978 required the filing of a federal tax return to claim the credit. For many taxpayers, claiming the credit was the only reason for filing a tax return, since they had no other reportable income for tax purposes.

While the total number of taxable tax returns filed in Canada for taxation year 1978 increased by less than 1% from taxation year 1977, the number of non-taxable tax returns increased from 3,821,173 in 1977 to 5,507,024 in 1978 - a rise of over 44%. Such a significant increase would result in substantial escalations in material and processing costs for the federal government.

Budget Year	Federal Tax Initiative
1978	Introduction of refundable child tax credit
1983	Introduction of Scientific Research Tax Credit(SRTC) program
1985	Introduction of life-time capital gains tax exemption
1986	Introduction of refundable sales tax credit
1989	Recovery (clawback) of social payment transfers of Old Age Security and family allowances
1990	Confirmation of major pension reform changes effective January 1, 1991

While RCT was unable to provide a separate accounting of the cost of federal and provincial tax changes, an examination of federal statistical and expenditure estimates data provides some insight into the rising costs of PIT administration.

Given that the introduction of the more elaborate items listed above, such as the refundable child tax credit and refundable sales tax credit, have occurred since 1978, an analysis of increases in federal tax returns filed, national RCT expenditures and authorized person-years since that date provides some interesting results. Below is a summary table of increases between 1978, the year prior to introduction of the refundable child tax credit, and 1988, the last taxation year for which federal tax return statistics are available.

Year	Federal Tax Returns¹	Total RCT Expenditures²	Authorized Person-Years²
1978	14,320,313	\$368,012,000	16,177
1988	17,579,870	\$889,293,000	20,636
Increase (%)	22.8%	141.6%	27.6%

1. Source of Data: Revenue Canada Taxation: Taxation Statistics

2. Source of Data: Federal Expenditure Estimates for fiscal years 1978-79 to 1988-89

While it may not be possible to allocate administrative costs between federal and provincial PIT requirements, it is reasonable to assert that a larger proportion of increased administrative costs are associated with federal, rather than Ontario, tax policy changes. However, a specific proportionate splitting of expenditures between federal and Ontario initiatives would be speculative and so has not been attempted.

Implications of the Payment Schedule

As a result of pressure from the provinces for improved cash flow, instalment payment timing was revised in 1989. For an overview, see Appendix H. In addition to the complex dynamics of the number, timing and amounts of the payments are several other important considerations for Ontario.

The commencement date and protracted length of the payment schedule have a negative effect on Ontario revenue flows.

- For the 1991 taxation year, employers began to deduct and remit employee income tax on or before January 10, 1991. Ontario began to receive its share February 20, 1991;
- The protracted period of payment transfer results in Ontario receiving funds as late as March 1993 for taxes collected by the federal government for the 1991 taxation year. For all employees who have deductions of tax made by their employers, which comprises the vast majority of taxpayers, and for those making instalment payments, RCT has these funds by December 31, 1991; and
- The negative effects on revenue flows are compounded by the fact that experience over the last nine years shows that, when compared with original federal estimates, large adjustments have been made in Ontario's favour in six of those years.

Delays Between Tax Remittances and Transfers to Ontario

Based on Revenue Canada, Taxation information, 71.2% of personal income tax revenues from employer remittances are received from employers which must remit at least twice monthly. The remaining 28.8% of personal income tax revenues are received from employers required to remit monthly. Of all personal income tax revenue received, 86% is derived from employer remittances, with the remaining 14% split equally among instalment payments, tax paid on filing, and taxes paid in arrears.

Using the 1989 taxation year as an example, there was a time lag of 25 calendar days between the earliest remittance of federal and provincial personal income tax by employers (Jan. 25, 1989) to Revenue Canada, Taxation, and first receipt of transfer of funds by Ontario (Feb. 20, 1989).

Based on Finance Canada's first estimate, each payment to Ontario of its personal income tax for the 1989 taxation year was \$249,372,000. On the following page is an illustration showing the compound daily interest effect that accrues to the federal government as a result of the delay in tax remittance receipt by RCT and transfer of same to Ontario. For purposes of illustration, an annual interest rate of 11% (compounded daily) has been used, the rate and computation method in effect at the time of the first estimate for the 1989 taxation year.

Illustration

Payment amount	\$249.372 million
Amount emanating from employer remittances (86%)	\$214.46 million
Amount attributable to employers remitting:	
a) twice monthly (71.2%)	\$152.70 million
b) monthly (28.8%)	\$61.76 million
Interest cost @ 11% per annum, compounded daily, on delay between	
1. 50% of first, twice-monthly remittance (Jan. 25/89) and transfer to Ontario (Feb. 20/89) 25 days	\$0.58 million
2. 50% of second, twice-monthly remittance (Feb. 10/89) and transfer to Ontario (Feb. 20/89) 10 days	\$0.23 million
3. monthly remittance (Feb. 15/89) and transfer to Ontario (Feb. 20/89) 5 days	\$0.09 million
Total Interest Cost (1 + 2 + 3)	\$0.90 million

Effect of Interim and Final Adjustments

The total amount of adjustments (interim & final) in Ontario's favour from taxation years 1981-1989, inclusive, has been **\$4.32 billion**. Of particular concern, is the trend established over the last five complete taxation years. The amount of adjustment in Ontario's favour has averaged **\$725.2 million**, with the yearly amount ranging from a low of \$454 million for taxation year 1985 to over **\$893 million for taxation year 1987**.

On the following page is a yearly review of all payments for taxation years 1981 to 1989 compared with original federal estimates of Ontario personal income tax due to the province.

ESTIMATED FEDERAL AND ACTUAL ONTARIO PIT PAYMENTS

(\$ million)

TAX YEAR	FIRST EST. ¹	ACTUAL PYMTS ¹	INTERIM ADJ.	FINAL ADJ. ²	TOTAL REC'D	VARIANCE TO EST. \$ M	%
1981	4,061	4,468	332	19	4,819	+ 758	+18.7
1982	5,552	5,491	15	32	5,538	- 14	- 0.3
1983	5,865	5,852	0	-36	5,816	- 49	- 0.8
1984	6,920	6,309	233	99	6,641	- 279	- 4.0
1985	6,439	6,800	407	47	7,254	+ 815	+12.7
1986	7,848	8,072	355	309	8,736	+ 888	+11.3
1987	8,890	8,895	744	149	9,788	+ 897	+10.1
1988	10,072	10,268	598	294	11,160	+1,088	+10.9
1989	11,526	12,389	537	186	13,112	+1,586	+13.8

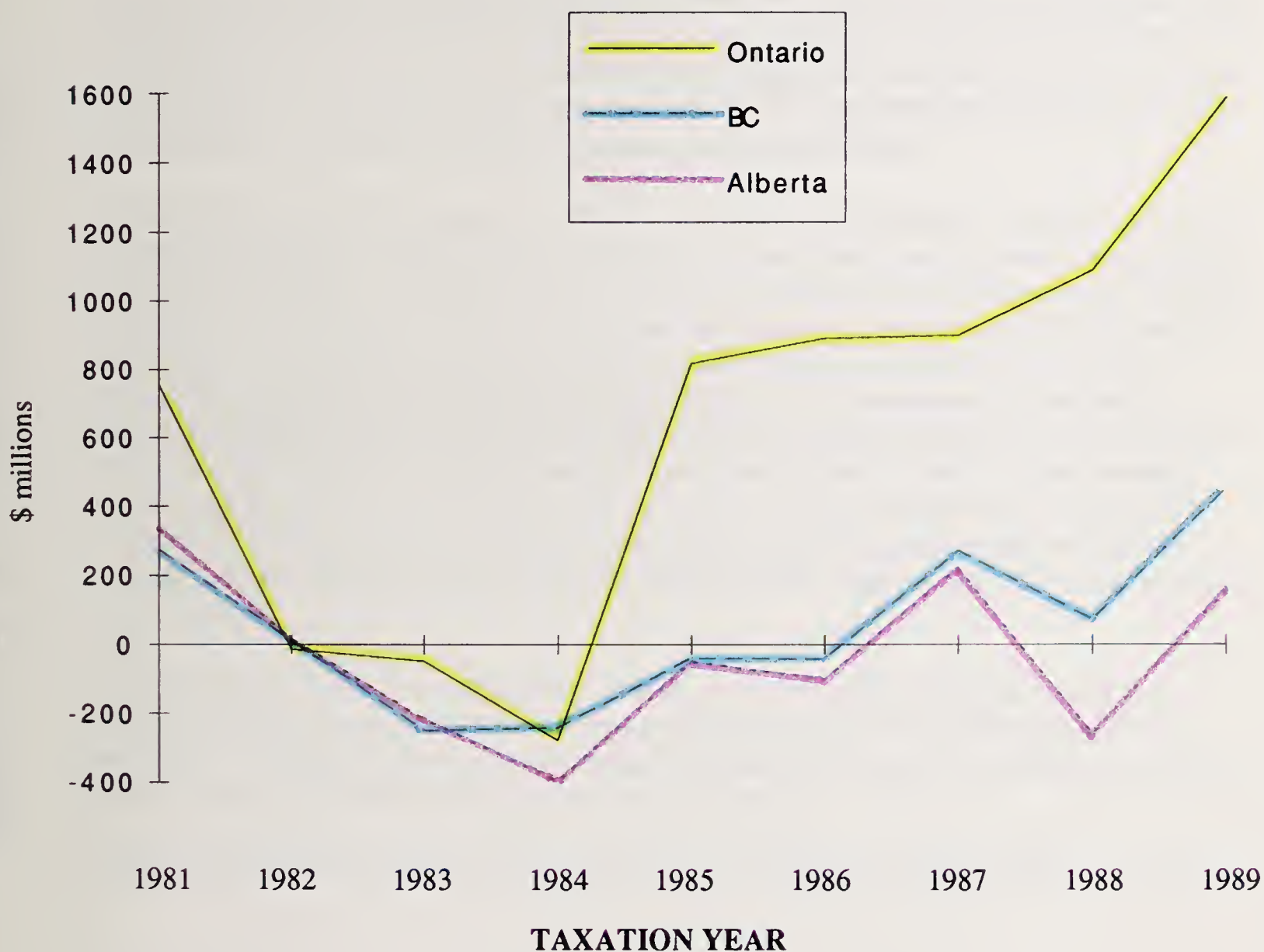
1. Net of Ontario Tax Credits

2. Net of March adjustment for Ontario tax credits and administration fee

SOURCE: Department of Finance Canada

Depicted in graphic form, below is a chart which demonstrates a nine-year history of differences between original federal estimates of PIT and actual amounts paid to Ontario, British Columbia and Alberta.

VARIANCE - FIRST ESTIMATE VS. ACTUAL PAYMENTS



The sharp increase in the amounts after taxation year 1984 and the steady rise in the incline of the slope since that year are of particular concern to Ontario.

Part of the explanation may relate to changes in tax revenues as a consequence of the Canadian recession in 1981-82. Since the economic effects of the recession were most acutely felt in 1981 and 1982, actual personal income tax receipts could be expected to be lower than original Finance Canada estimates. However, by 1983, and certainly in 1984, the very large negative variance (-279 million) appears incongruous with the strong economic recovery that occurred in 1983 and ensuing years. In the absence of specific federal or provincial tax policy changes in 1984, there appears to be no concrete explanation for the variances.

Based on the pattern of variances of British Columbia and Alberta, which show a greater degree of symmetry with each other than with Ontario, it would appear that the proportion of national BFT emanating from Ontario was significantly underestimated, particularly in the period from 1984 onwards. Conversely, the proportion of national BFT emanating from British Columbia and, particularly, Alberta would appear to have been overestimated.

Perhaps, interprovincial migration may have some bearing on the pattern of variances. During periods of recession, or strong growth, specific economic sectors may be subject to substantial contraction or growth. In these periods, the effects of interprovincial migration tend to deflate provincial PIT revenues in provinces experiencing economic contraction, and thus a decline in population base (or a lower rate of growth in population base), and inflate provincial PIT revenues in provinces experiencing economic growth, with a consequent net increase in provincial migration levels. If this is the case, the Ontario effects of the most recent recession bear watching. Since the economic declines were concentrated in Ontario's manufacturing sector, migration flows out of Ontario may contribute to an over-estimation of Ontario PIT revenues by Finance Canada for taxation year 1991. The November 1991 revised Finance Canada forecast, as well as interim and final adjustments for taxation year 1990, may provide further insight.

In any event, the model is a problem for Ontario, since the model's declining record as an accurate forecasting mechanism has become progressively more of a disadvantage for the province. Although all tax revenues owing are eventually transferred to Ontario, the extended cash flow period involved is contrary to Ontario's interests.

The scenario on the following page illustrates the very significant financial effects for Ontario.

Bridge Financing Costs to Cover Delayed Receipt of Funds

In this case, a common scenario in recent years, government expenditures exceed revenues (Budget deficit). The government must borrow to meet its expenditure obligations. Due to the delays in receiving its personal income taxes from Finance Canada, Ontario's net receipts from income taxes are reduced by the carrying costs of funds borrowed as "bridge financing" until the funds are received.

Since all personal income taxes for a given taxation year must be remitted by April 30th of the following taxation year, for purposes of illustration, it is assumed that the total amounts of interim and final adjustments were borrowed by Ontario for the period from May 1st of the taxation year following the taxation year to which the adjustments relate, until receipt of the funds from Finance Canada. The average rate of interest charged on overdue taxes by RCT between May 1st 1990 and March 31st 1991 was 15.5%, compounded daily. It is assumed that no payments were made on the money borrowed during the entire period. Ontario PIT data is used from final tax revenue receipts for the 1989 taxation year, the latest complete taxation year data available.

Illustration

1989 taxation year interim adjustment amount	\$537 million	
Total number of days for compounding of interest (payment received January 7, 1991)	251	
Compound interest costs		\$60.39 million
1989 taxation year final adjustment amount	\$186 million	
Total number of days for compounding of interest (payment received March 28, 1991)	331	
Compound interest costs		\$28.06 million*
Total interest costs		\$88.45 million

The total interest cost of \$88.45 million also represents the total interest charged by RCT on a similar amount of outstanding taxes for the same period using the same interest rate.

Effects of Unilateral Federal Decisions

As mentioned earlier, member provinces of the Federal-Provincial Tax Collection Agreement relinquish considerable autonomy over provincial tax policy to Revenue Canada, Taxation (RCT) as a condition of membership. This section outlines three examples of how Ontario is disadvantaged by this arrangement.

Audit Coverage

In recent years, federal government departments, including Revenue Canada, Taxation (RCT), have been subjected to increasingly severe expenditure constraints. As reflected in published RCT estimates information, constraints have resulted in reductions in discretionary audit and compliance activity.

These reductions have had an adverse, if unintended, effect on Ontario personal income tax revenues. For every \$100 foregone in Basic Federal Tax (BFT), with an Ontario personal income tax rate of 53% of BFT, Ontario loses \$53 in Ontario personal income tax. This does not include further losses associated with an Ontario surtax applied to taxpayers with an Ontario tax of \$10,000 or more.

While the amounts of tax revenues foregone are difficult to quantify, a recent study of the United States Internal Revenue Service (IRS) provides a basis for comparison.¹ During the period under review, 1978 to 1986, the IRS also experienced budget reductions. Audit coverage of individual taxpayers declined from just over two per cent to just over one per cent.

The study concluded that the decline in audit coverage resulted in a reduction in **direct** tax revenues and penalties of **\$2.6 billion** in 1986. More striking, was the estimate of the ratio and amount of **indirect** revenue losses. Indirect revenue is generated through increased taxpayer compliance induced by perceived prospects of detection through audit activity. The higher the level of audit coverage, the greater the taxpayers' awareness that they may be detected if they do not comply with the law.

The study data produced a ratio of 1:6, that is, for every dollar of direct revenue acquired through audit activity, an additional six dollars of indirect revenues were generated. Using this ratio, the reduction in audit activity resulted in losses of **\$15.6 billion** in indirect revenues in 1986, a figure which represented four per cent of all reported federal taxes in that year.

1. The Effect of Audit Rates on the Federal Individual Income Tax, 1977-1986, National Tax Journal, December, 1990.

Using study results in the Canadian context may require some adjustment. On the assumption that the level of taxpayer compliance in Canada is slightly higher than in the United States, this would reduce the ratio of direct/indirect revenues. For purposes of demonstration, the Canadian ratio has been modified to 1:3.

Using RCT published data for the 1989 taxation year (the latest available information), a decline in audit coverage proportionate to the U.S. experience, computed within the Canadian context, results in significant tax revenue losses for Ontario.¹ The scenario on the following page outlines the potential effects.

1. For a description of RCT's examination and audit processes, refer to the essay entitled **Ontario PIT Administration** by Revenue Canada, Taxation.

The United States Experience

Total U.S. federal tax reported in 1986	\$390,000 million
Direct tax revenue lost due to reduced audits	\$2,600 million
% of total U.S. federal tax reported in 1986	0.67%

The Federal Canadian Equivalent

Total Basic Federal Tax (BFT) reported in Canada in 1989	\$53,230 million
Direct BFT lost due to reduced RCT audits (\$53,230 million x 0.67%)	\$357 million
Indirect BFT lost due to reduced RCT audits (\$357 million x 3)	\$1,071 million
Total direct and indirect BFT lost due to reduced RCT audits (\$357 million + \$1,071 million)	\$1,428 million

The Ontario PIT Effect

% of 1989 total BFT attributable to Ontario	45.97%
Amount of direct and indirect BFT lost attributable to Ontario (1,428 x 45.97%)	\$656 million
1989 Ontario PIT rate as a % of BFT	52%
Loss of Ontario PIT due to reduced RCT audits (\$656 million x 52%)	\$341.12 million

With potential federal BFT losses of over \$1.4 billion, it is clear that reductions in RCT audits are not purposely designed to reduce Ontario PIT revenues. However, unilateral federal decisions resulting in audit reductions, with neither provincial consultation nor even communication of actions being taken, leave Ontario with no recourse of redress under the terms of the Tax Collection Agreement. No provision of the Agreement has been breached, since it contains no standard audit coverage commitment by RCT.¹

Audit coverage data supplied by RCT confirm the reduction in audit coverage. Since 1979-80, RCT audit coverage rates have declined by 63% for farmers and fishermen, 56% for professionals and 58% for unincorporated businesses. Clearly, there are substantial negative effects for Ontario PIT revenues based on confirmed declines in RCT audit coverage rates. For a complete review of RCT data on audit coverage rates, see **Appendix I**.

Province of Residence Verification

As shown in the illustration on page 13, provincial personal income tax (PIT) liability is determined by applying the provincial PIT rate to the amount of Basic Federal Tax (BFT). Each taxpayer's provincial PIT liability is based upon the provincial PIT rate of the taxpayer's declared province of residence on December 31st, as indicated on the federal tax return.

From a standpoint of federal PIT liability, province of residence is of no consequence for Canadian taxpayers. The same amount of BFT for any given taxpayer is payable, regardless of the province of residence of the taxpayer. However, the taxpayer's province of residence, as of December 31st of any given taxation year, is very important for provincial PIT revenue considerations.

In taxation year 1990, for example, with provincial PIT rates ranging from a high of 62% of BFT in Newfoundland to a low of 44% of BFT in the Northwest Territories, there were significant provincial PIT advantages to be a taxpayer resident in the Northwest Territories rather than Newfoundland on December 31, 1990. A taxpayer with a BFT amount of \$10,000 would have a provincial PIT liability of \$6,200 in Newfoundland, but only \$4,400 in the Northwest Territories, a difference of \$1,800.

An Ontario-Northwest Territories comparison (Ontario's provincial PIT rate for taxation year 1990 was 53% of BFT) produces a \$900 differential advantage to the taxpayer resident in the Northwest Territories on December 31, 1990.

Clearly, provinces, particularly those with higher provincial PIT rates, would want to ensure that provincial PIT revenues are protected from false provincial residency declarations made by taxpayers. To ascertain the degree of provincial protection provided by RCT, the Ministry of Revenue sent a letter dated June 28, 1991 to RCT requesting copies of procedures used to verify the province of residence declared by taxpayers in federal tax returns.

1. While not specifically required by the terms of the Agreement, RCT has agreed to audit OTC claims on a population-based formula. However, federal authorities have refused to expand audit coverage to accommodate the OHOSP program or changes to the calculation of the Ontario Tax Reduction Program. Similarly, it appears that tax credit claims made under the Ontario Investment and Worker Ownership program may not be subjected to federal audit.

The Ministry received a written response dated September 30, 1991 from RCT. According to the RCT response, any declaration of province of residency indicated on the federal tax return is accepted without verification. There is no test, either upon receipt of the federal tax return, or in any subsequent random audit, to verify that taxpayers declare their true province of residence. This practice jeopardizes the revenue base of provinces with higher provincial PIT rates and may inflate the true provincial PIT entitlement of provinces with lower provincial PIT rates.

The provincial PIT rate differential, when combined with applicable provincial surtax rates, may induce high income taxpayers to make false declarations of provincial residency when filing federal tax returns. At present there is no validation test to detect such abuse. Neither do the provinces have any avenue of redress under the terms of the Tax Collection Agreement, since none of its provisions have been breached.

Provincial Allocation of Business Income

Another area of interest expressed in the Ministry of Revenue letter dated June 28, 1991 to RCT concerned verification of taxpayer declarations of provincial allocations of business income. Self-employed taxpayers who have permanent business establishments in more than one province must allocate their business income in proportion to the provincial source of business income for taxation purposes. As with province of residency, this allocation has no bearing on BFT, since federal PIT liability is uniform across Canada.

However, as with provincial residency considerations, there are significant implications for provincial PIT revenues. The total provincial PIT liability of a self-employed taxpayer with permanent business establishments in more than one province is strongly influenced by the proportion of taxable income attributable to each province. For example, if total BFT were \$10,000, with the provincial source of taxable income divided equally between Ontario and the Northwest Territories, the combined provincial PIT for taxation year 1990 would have been \$4,850 (\$2,650 in Ontario PIT + \$2,200 in Northwest Territories PIT).

If, however, the taxpayer declared that 25% of taxable business income had an Ontario source and the remaining 75% had a Northwest Territories source, the combined provincial PIT would have been \$4,625 (\$1,325 in Ontario PIT + \$3,300 in Northwest Territories PIT). The change in provincial allocation of taxable business income would have resulted in a reduction in the taxpayer's total provincial PIT liability of \$225 (\$4,850 - \$4,625). More importantly for Ontario, Ontario PIT revenues would have been reduced by \$1,325 (\$2,650 - \$1,325) and the Northwest Territories PIT revenues would have been inflated by \$1,100 (\$3,300 - \$2,200).

Once again, provinces with higher PIT rates would expect assurance that the taxpayer's declared provincial allocation of business income is being subjected to some degree of verification to deter abuse. RCT's written response to the Ministry of Revenue request contained copies of operational procedures, statistical summaries of resources allocated and results achieved for the fiscal year ending March 31, 1991.

For fiscal year 1990-91, the total RCT Canada-wide budget contained authorization for 21,888 person-years. Of this total, 6.38 person-years (0.03% of the total) were budgeted for verification of provincial allocation of business income. Only 2.4 person-years were actually used for this purpose, of which 0.18 person-years were devoted to verification of provincial allocation of business income reported by individuals.

In addition, RCT reported that in fiscal year 1990-91, there were no audits of taxpayer files for provincial re-allocation of business income from, or to, agreeing or non-agreeing provinces under the Tax Collection Agreement. Consequently, there were no dollar value re-adjustments to declared taxpayer allocations of provincial PIT.

The total absence of audit or verification, when discerned by taxpayers, may induce a greater incidence of false taxpayer declarations. Once again, however, since no provision of the Tax Collection Agreement has been violated, provinces have no legal recourse to change federal audit or verification practices.

Conclusions

Given the financial constraints imposed on RCT expenditure budgets in recent years, it is understandable that federal authorities would seek to deploy scarce resources for the best possible protection of federal PIT revenues. Since neither the province of residence nor the provincial allocation of business income have any bearing on federal PIT revenues, they are obviously not important areas of federal concern.

By contrast, with respect to corporations tax, provincial allocation adjustments by the Ministry of Revenue indicate significant non-compliance. In fiscal year 1990-91, total tax recoveries from the field audit of corporations were \$115 million. Of this, approximately \$14.5 million, or 13%, resulted from increased provincial allocations to Ontario. While permanent establishments in more than one province are less common in unincorporated businesses, it is surprising that Revenue Canada, Taxation audits of such businesses resulted in no provincial allocation changes whatsoever in 1990-91.

Given current federal practices, provinces face significant exposure to taxpayer abuse, and consequent negative effects on provincial PIT revenues. Given the increasing burden of taxation, taxpayer awareness of weaknesses in these areas may be expected to result in growing revenue losses in provincial PIT revenues as taxpayers exploit the absence of adequate audit and verification practices.

Overall Financial Effects

In view of the financial analysis above, Ontario does not receive a “free” service from the federal government. In fact, as a result of “bridge-financing” costs and foregone revenues from reduced RCT audit levels, Ontario is “paying” for the full cost of federal administration of the Ontario component of the personal income tax system, and in 1989-90 experienced a financial loss of \$335.7 million.

The table on the following page outlines the relevant data for the 1989-90 fiscal year, using financial data from that fiscal year and attributing costs at a rate of 21% of national RCT expenditures. Costs to Ontario are based on the 1989 taxation year, the latest taxation year for which complete financial data are available. The “cost” to Ontario is a conservative estimate of present-day costs for the following reasons:

1. The estimated cost of federal administration uses 1989-90 fiscal year expenditure data. This ensures that more recent expenditure year information is used in estimating federal costs than is used for estimating Ontario costs when such costs are based on the 1989 taxation year.
2. The “bridge-financing” costs associated with delayed receipt of Ontario PIT funds due to the prolonged payment schedule have been increasing as the amount of interim and final adjustments in Ontario's favour continue to grow. In addition to the “bridge-financing” costs cited on pages 26 and 30, similar costs are incurred in the timing of regular payment transfers to Ontario. For example, from taxation year 1990 onwards, by the end of December of each taxation year, the federal government would have received:
 - 51 of 52 payments from employers remitting weekly;
 - 23 of 24 payments from employers remitting twice monthly; and
 - 3 of 4 payments from taxpayers paying by quarterly instalment.

By contrast, Ontario would have received only 43 of the 48 regular instalment payments of Ontario PIT from Finance Canada by the end of December.

3. Since 1988-89, net ancillary revenues collected via interest on taxes in arrears and penalties shows a sharp increase. Federal measures to increase these amounts suggest substantial future growth. Ontario receives none of the funds attributable to Ontario PIT.
4. The declining level of RCT audit coverage suggests that direct and indirect Ontario PIT revenue losses will increase in future beyond the 1989 taxation year estimate. In addition, the absence of verification tests for taxpayer declarations of province of residence and provincial allocation of business income, while not readily quantifiable, will have negative effects on Ontario PIT revenues.

Estimated Federal Cost of Ontario PIT Administration (1989/90 fiscal year)	\$205.45 million
Less:	
Fee recovered from Ontario for administration of Ontario Tax Credits (1989 taxation year)	\$3.80 million
Net Federal Cost of Ontario PIT Administration (1989-90 fiscal year)	\$201.65 million

Indirect Costs to Ontario

A. Cost of delayed receipt of PIT funds from:		
i) remittances (1989 taxation year payment schedule)	\$ 0.90 million	
ii) interim/final adjustment (1989 taxation year)	\$88.45 million	
B. Net ancillary federal revenues from arrears interest, penalties, fines and write-offs attributable to Ontario (1989-90 fiscal year)	\$106.88 million	
C. Ontario PIT revenue losses from reduced RCT audit activity (1989 taxation year)	\$341.12 million	
Total	\$537.35 million	\$537.35 million

Even if Ontario's ongoing cost of administration of its own personal income tax system were equivalent to the net federal estimated cost of \$201.65 million (most likely a worst case scenario of cost projections), Ontario's net indirect costs as calculated above are \$335.7 million higher than net federal costs.

Non-Financial Considerations

There are several other important factors that bear discussion as well. Unlike financial data, which is easily quantifiable, these factors are qualitative in nature. Their relative importance and weight in the overall evaluation of the Tax Collection Agreement are dependent upon the criteria used by individual evaluators.

From policy and political perspectives, these factors, although they tend to defy traditional quantitative analysis, may be as important, or more important, than financial considerations alone.

Reduced Provincial Flexibility

Provincial acceptance of restrictions in the Agreement limit the provinces from using the personal income tax system as a vehicle for introducing economic or tax policy instruments. For example:

- Using the personal income tax system for new provincial taxes such as a wealth tax and speculation tax would require the approval of the federal government. If such approval were denied, Ontario must implement its own administrative system;
- Changes such as different personal exemption rates, varied treatment of differing types of income, or higher exemptions for child care expenses to implement Ontario tax policy changes would require a departure from the current federal tax base and calculation based on “basic federal tax” (BFT).

Previous efforts to change the base to taxable income or net income rather than BFT have been denied.¹

- The Agreement restricts Ontario from using the personal income tax system as a vehicle for initiatives designed to encourage investment in Ontario-based companies only. Although the federal Labour Sponsored Venture Capital Corporation (LSVCC) program allows for some freedom from this restriction, all provincial initiatives must conform to federal criteria.

Quebec, which is not a party to the Agreement, uses its provincial personal income tax system as a vehicle for the successful Quebec Stock Savings Plan, an instrument of economic policy designed to encourage investment in Quebec-based companies. The Quebec Plan is not restricted by federally-defined criteria.

1. In the 1991 Federal Budget tabled on February 26, 1991, the Finance Minister indicated that the federal government is prepared to consider requests from the provinces for revisions to the Tax Collection Agreement which would provide greater flexibility. Mentioned specifically was the potential for provinces to levy the provincial tax rate against taxable income rather than Basic Federal Tax. A federal discussion paper was released on June 25, 1991.

By contrast, unlike many other provinces, Ontario's provincial corporate tax system is administered directly by Ontario, not via the Tax Collection Agreement. Consequently, provincial corporate tax changes may be implemented without the need for federal approval, leaving Ontario free to choose among a variety of options designed for its unique needs.

Finally, the Agreement limits Ontario in areas of provincial tax rate changes and their timing. Changes must be by multiples of one-half percentage point. The federal government must be notified by October 15th of the year if the tax rate changes are to become effective on January 1st of the following year.

Raising Revenue - Using the Personal Income Tax (PIT) System

The PIT system is considered the cornerstone of fiscal design. Generally held as the most progressive form of taxation, it is viewed as the best instrument to achieve:

- horizontal - (equal treatment of equals) tax policy objectives of equity and neutrality; and
- vertical - (ability to pay) equity.

Much of the criticism that now plagues tax jurisdictions relates not to these objectives, but more to the increasing burden of tax and to perceived inequities in the current PIT system that deviates from the principles espoused. For example:

- the taxing of all interest on savings, without allowing a discount for inflation, is perceived as unfair;
- by contrast, many capital gains are only partially taxed; and
- accumulated wealth, not otherwise subject to income tax and/or capital gains tax, is not taxed at all.

Being locked into such a system through the Collection Agreement limits Ontario from using the PIT system to correct some of its perceived inequities.

Ontario has introduced policy initiatives restricted within the PIT system (e.g. Small Business Development Corporation program and the Employee Share Ownership Plan), but operation outside the PIT system usually means higher administrative costs and a more fragmented approach to the achievement of integrated objectives.

Complications for the Provincial Treasurer

The December to January period is traditionally a difficult time for the provincial Treasurer. As plans begin for the Ontario Budget for the fiscal year commencing April 1st, it is important to know what the expected budget position will be for the fiscal year ending March 31st.

With adjustment payments in January and March, the amount of which is unknown until declared by the federal government, the Treasurer can only speculate about the fiscal year-end position of the government.

If a deficit position is forecast, the Treasurer needs to know:

- the amount of the deficit;
- the level of government borrowing necessary; and
- the effect the deficit may have on social, economic and fiscal plans for the upcoming fiscal year.

Using present circumstances, the Treasurer has forecast a provincial deficit of \$9.7 billion for fiscal year 1991-92. While expenditure levels may be controlled directly, the Treasurer has no control of the tax revenues which Ontario will receive from the federal government as adjustments for the 1990 taxation year. This leaves the Treasurer without a clear picture of the government's fiscal year end budget position.

Federal-Provincial Relations

The Tax Collection Agreement has been a long-standing example of federal-provincial co-operation. While the Agreement has undergone many changes during its lifetime, it is perceived as a pillar of harmony between the federal government and nine provinces.

Ontario's Premier has expressed deep concerns about the future of the country and the province's role in improving national harmony. Any considerations of radical changes to the Agreement, or withdrawal from it, should take cognizance of potential effects on federal-provincial relations and the perception of a further fracture in national cohesion. With present negotiations concerning a revised Canadian Constitution, which could result in a re-defined sharing of federal-provincial powers and authority, the future of the Tax Collection Agreement may affect, and be affected by, other issues of paramount federal-provincial concern. It is within this broader public policy context that decision makers may weigh the contents of this paper.

Conclusion

The Agreement struck in April 1962, while amended on numerous occasions, has been in effect for over 29 years. Long heralded as a symbol of federal-provincial fiscal co-operation and tax harmony, the Agreement is under increasing pressure as provinces seek a re-defined sharing of federal-provincial powers and authority.

From a provincial perspective, the current shortcomings of the Agreement must be counter-balanced with considerations of:

- how the province wishes to use the personal income tax system as a vehicle for implementation of social, economic and tax policy;
- alternatives to the present arrangement;
- costs to the province of these alternatives;
- the federal response to these alternatives; and
- the potential effects on future federal-provincial relations.

APPENDIX A

FEDERAL ESTIMATES PROCESS OF ONTARIO PERSONAL INCOME TAX 1991 TAXATION YEAR

Federal Estimates Process of Ontario Personal Income Tax 1991 Taxation Year

Finance Canada's Economic Model

Each year, usually at the time of the federal budget in February, Finance Canada estimates the amount of provincial income tax attributable to each member province of the Federal-Provincial Tax Collection Agreement.

Data which is fed into Finance Canada's economic model includes:

- projected real Gross Domestic Product (GDP);
- projected changes in the Consumer Price Index (CPI);
- projected employment statistics;
- data on real personal income;
- quarterly estimates of Canadian Income and Expenditure Accounts (CIEA);
- statistical data published by Revenue Canada, Taxation (the "Green Book") for prior taxation years; and
- Public Accounts figures, as well as latest detailed monthly personal income tax collections data.

The Basic Federal Tax (BFT) forecast produced by Finance Canada's economic model is first prepared on a Canada-wide scale. Then provincial shares of national BFT are attributed on the basis of actual ratios from the last complete taxation year, which is two years previous to the taxation year being forecast.

More recent data, which may, when analyzed in the Finance Canada economic model, produce differing provincial shares of BFT, are not used until subsequent revisions to the initial estimate. These revisions usually occur in the July/August period and in November.

From the BFT forecast emanating from Finance Canada's economic model, an adjustment of estimated BFT is made "to more closely approximate estimated BFT assessments from prior taxation years". This adjustment is an indication of the margin of inaccuracy associated with the results produced by the economic model.

Using the ten-year taxation year period from 1982-91, the extent of the estimated BFT adjustment needed "to more closely approximate estimated BFT assessments" has grown considerably. For taxation year 1982, the national BFT adjustment amount was \$60 million. By taxation year 1991, the BFT adjustment amount has increased to \$1.9 billion, an increase of 3,066.7%!

Even in relative terms, the BFT adjustment amount has increased dramatically as a percentage of total BFT estimated by Finance Canada's economic model.

For taxation year 1982, the \$60 million BFT adjustment amount was 0.19% of the \$31.730 billion of national BFT estimated by Finance Canada's economic model. For taxation year 1991, the \$1.9 billion BFT adjustment amount is 3.05% of the \$62.3 billion of national BFT estimated by Finance Canada's economic model, an increase of 1,505.3%!

Below is a table for each taxation year from 1982 to 1991. The data shows how the BFT adjustment amount has increased to compensate for the growing inaccuracy of Finance Canada's economic model.

Taxation Year	BFT Adjustment Amount (\$M)	Total BFT Estimate (\$M)	BFT Adjustment as % of Total BFT Est.
1982	60	31,730	0.19%
1983	400	33,320	1.20%
1984	400	36,549	1.09%
1985	400	34,800	1.15%
1986	600	38,900	1.54%
1987	600	42,500	1.41%
1988	600	45,100	1.33%
1989	1,000	49,300	2.03%
1990	1,165	54,900	3.01%
1991	1,900	62,300	3.05%

Using actual data from 1989, the most recent complete taxation year available, the BFT adjustment amount of \$1 billion was considerably lower than the total necessary. Total actual BFT for 1989 taxation year was \$52.23 billion, \$2.93 billion, or 5.9% higher than the original Finance Canada economic model of \$49.3 billion.

For the associated cash flow effects that these inaccurate estimates have on Ontario personal income tax revenues, see the chart on page 27.

Source of Data: Finance Canada reports

Sequence of Events

Below is the full sequence of events, and timing, related to the determination of payments for the 1991 taxation year.

Item	Event Date	Comments
Initial Estimate	Feb. 1991	<ul style="list-style-type: none"> • use 1989 and prior taxation years' Basic Federal Tax (BFT) collected in Canada as at Dec. 31, 1990 • estimate of 1991 BFT for Canada from Finance Canada economic model • determine amount and percentage of BFT collected from Ont. • multiply 1991 BFT for Canada by Ontario percentage of Canada BFT from 1989 taxation year to determine gross estimate of 1991 Ont BFT

Item	Event Date	Comments
		<ul style="list-style-type: none"> • reduce gross 1991 Ont BFT by estimated impact of 1991 federal tax policy changes and BFT amounts attributed to Canadians living abroad • re-compute percentage of net Canada 1991 BFT to be collected from Ontario • multiply net 1991 Ont BFT by Ont tax rate to determine gross 1991 Ont personal income tax (PIT) • adjust 1991 Ont gross PIT by: <ol style="list-style-type: none"> 1. subtracting the estimated amount of Ontario Tax Reductions; 2. adding estimated amount of provincial surtaxes; 3. adding the estimated amount of unapplied taxes for Ont. • divide adjusted 1991 Ont PIT by 48 to determine amount of each payment as per schedule

Appendix A (cont'd)

		<ul style="list-style-type: none">• estimate amount of Ont tax credits from data provided by Ontario Ministry of Treasury and Economics• reduce payment amounts for payments #8-#31 inclusive based on equal portion of estimated Ont tax credits
Second Estimate	August 1991	<ul style="list-style-type: none">• follows exactly the same process as first estimate, using 1989 and prior years' tax data as at Feb. 28, 1991 instead of Dec. 31, 1990
Third Estimate	November 1991	<ul style="list-style-type: none">• follows the same process again, using data based on 1990 taxation year as of Oct. 15, 1991 and revised economic outlook prepared by Finance Canada
Interim Adjustment	December 1992	<ul style="list-style-type: none">• based on 1991 taxation year data assessed as of Oct. 15, 1992
Final Adjustment	March 1993	<ul style="list-style-type: none">• final determination of Ontario tax revenue for the 1991 taxation year using Dec. 31, 1992 data

APPENDIX B

FEDERAL ESTIMATES AND PAYMENTS

ONTARIO PERSONAL INCOME TAX

1990 TAXATION YEAR

Federal Estimates and Payments Ontario Personal Income Tax

1990 Taxation year

First Estimate February 1990

Amount of Basic
Federal Tax in
Canada for tax
year 1988 as at
Dec. 31, 1989:

\$48,191,525,000

Amount and %
collected from
Ontario:

\$22,084,622,000

45.826776%

Finance Canada
estimate of 1990
total Basic
Federal Tax for
Canada before
Budget Measures:

\$57,074,024,000

Second Estimate July 1990

Amount of Basic
Federal Tax in
Canada for tax
year 1988 as at
Dec. 31, 1989:

\$48,191,525,000

Amount and %
collected from
Ontario:

\$22,084,622,000

45.826776%

Finance Canada
estimate of 1990
total Basic
Federal Tax for
Canada before
Budget Measures:

\$57,722,269,000

Third Estimate November 1990

Amount of Basic
Federal Tax in
Canada for tax
year 1989 as at
Oct. 15, 1990:

\$53,779,028,000

Amount and %
collected from
Ontario:

\$24,748,009,000

46.017955%

Finance Canada
estimate of 1990
total Basic
Federal Tax for
Canada before
Budget Measures:

\$59,667,315,000

Appendix B (Cont'd)

First Estimate February 1990	Second Estimate July 1990	Third Estimate November 1990
Estimated amount of Basic Federal Tax from Ontario:	Estimated amount of Basic Federal Tax from Ontario:	Estimated amount of Basic Federal Tax from Ontario:
\$57,074,024,000 x 45.826776%	\$57,722,269,000 x 45.826776%	\$59,667,315,000 x 46.017955%
\$26,155,185,000	\$26,452,255,000	\$27,457,678,000
Estimated 1990 vs 1988 reduction of Budget Measures Canada/Ontario:	Estimated 1990 vs 1988 reduction of Budget Measures Canada/Ontario:	Estimated 1990 vs 1989 reduction of Budget Measures Canada/Ontario:
\$676,709,000 \$428,278,000	\$676,709,000 \$428,278,000	\$476,715,000 \$343,301,000
Net Basic Federal Tax for Canada/ from Ontario:	Net Basic Federal Tax for Canada/ from Ontario:	Net Basic Federal Tax for Canada/ from Ontario:
\$56,397,314,000 \$25,726,907,000	\$57,045,560,000 \$26,023,977,000	\$59,190,600,000 \$27,114,377,000
1990 Ontario rate as percentage of Basic Fed. Tax:	1990 Ontario rate as percentage of Basic Fed. Tax:	1990 Ontario rate as percentage of Basic Fed. Tax:
53%	53%	53%

Appendix B (Cont'd)

First Estimate February 1990

Estimated 1990
gross Ontario
personal income
tax:

\$25,726,907,000

x
53%

\$13,635,261,000

Less estimate
for Ontario tax
reduction:

\$50,000,000

Plus Ontario
surtax:

\$160,000,000

Plus Ontario
share of
unapplied taxes:

\$288,158,000

Total estimate of
Ontario personal
income tax 1990:

\$14,033,419,000

Second Estimate July 1990

Estimated 1990
gross Ontario
personal income
tax:

\$26,023,977,000

x
53%

\$13,792,708,000

Less estimate
for Ontario tax
reduction:

\$50,000,000

Plus Ontario
surtax:

\$160,000,000

Plus Ontario
share of
unapplied taxes:

\$287,650,000

Total estimate of
Ontario personal
income tax 1990:

\$14,190,358,000

Third Estimate November 1990

Estimated 1990
gross Ontario
personal income
tax:

\$27,114,377,000

x
53%

\$14,370,620,000

Less estimate
for Ontario tax
reduction:

\$50,000,000

Plus Ontario
surtax:

\$200,000,000

Plus Ontario
share of
unapplied taxes:

\$287,883,000

Total estimate of
Ontario personal
income tax 1990:

\$14,808,503,000

Appendix B (Cont'd)

First Estimate February 1990

payment amounts:

#1-47

\$292,363,000

#48

\$292,358,000

Estimate of
Ontario tax
credits for
1989 taxation year:

\$380,000,000

Amounts to be
deducted from
instalment
payments:

#8-30

\$15,833,000

#31

\$15,841,000

Second Estimate July 1990

payment amounts:

#1-23

\$292,363,000

#24-47

\$298,640,000

#48

\$298,649,000

Estimate of
Ontario tax
credits for
1989 taxation year:

\$380,000,000

Amounts to be
deducted from
instalment
payments:

#8-23

\$15,833,000

#24-31

\$15,834,000

Third Estimate November 1990

payment amounts:

#1-23

\$292,363,000

#24-39

\$298,640,000

#40-47

\$367,324,000

#48

\$367,322,000

Estimate of
Ontario tax
credits for
1989 taxation year:

\$380,000,000

Amounts to be
deductions from
instalment
payments:

#8-23

\$15,833,000

#24-31

\$15,834,000

APPENDIX C

TAX COLLECTION PAYMENTS: EFFECTS OF OVERLAPPING TAXATION AND FISCAL YEARS

TAX COLLECTION PAYMENTS:
EFFECTS OF OVERLAPPING TAXATION AND FISCAL YEARS

For the taxation year	1988		1989		1990		1991	
In the Fiscal Year	Estimate	Instalment	Estimate	Instalment	Estimate	Instalment	Estimate	Instalment
1989-90 April to July 1989				8 to 23. PIT 1 to 16 OTC				
August 1989			2nd PIT Estimates based on 1987 data as of Feb. 28/89	24 to 27. PIT 17 to 20 OTC				
Sept. to Nov. 1989			3rd re-calculation in Nov. based on revised economic outlook and use of Oct. 15/89 data	28 to 38. PIT 21 to 24 OTC				
December 1989	Interim Final PIT using 1988 tax assessed as of Oct. 15/89			40 to 43. PIT				
January 1989		Interim Final PIT		44 to 47. PIT				
February 1990				48. PIT	1st 1990 PIT estimates based on Dec. 31/88 data	1 to 3. PIT		
March 1990	Final Determination 1988 PIT using Dec. 31/89 BFT Data	Final PIT and OTC payment				4 to 7. PIT		
1990-91 April to July 1990						8 to 23. PIT 1 to 16 OTC		
August 1990					2nd PIT estimates based on 1988 data as of Feb. 28/90	24 to 27. PIT 17 to 20 OTC		
Sept. to Nov. 1990					3rd re-calculation in Nov. based on revised economic outlook and use of Oct. 15/90 data	28 to 38. PIT 21 to 24 OTC		
December 1990			Interim Final/PIT using 1989 tax assessed as of Oct. 15/90			40 to 43. PIT		
January 1991				Interim Final PIT		44 to 47. PIT		
February 1991						48. PIT	1st 1991 PIT estimates based on Dec. 31/90 data	1 to 3. PIT
March 1991			Final Determination 1989 PIT using Dec. 31/90 BFT Data	Final PIT and OTC payment				4 to 7. PIT
1991-92 April to June 1991								8 to 19. PIT 1 to 12 OTC
July 1991							2nd PIT estimates based on 1989 data as of Feb. 28/91	20 to 23. PIT 13 to 16 OTC
Aug. to Nov. 1991							3rd re-calculation in Nov. based on revised economic outlook and Oct. 15/91 data	24 to 39. PIT 17 to 24 OTC
December 1991					Interim Final PIT using 1990 Tax assessed as of Oct. 15 1991			40 to 43. PIT
January 1992						Interim Final PIT		44 to 47. PIT
February 1992								48. PIT
March 1992					Final determination 1990 PIT using Dec. 31/91 BFT Data and Feb. 29/92 CTAI data	Final PIT and OTC payment		
1992-93 December 1992							Interim Final PIT using 1991 tax assessed as of Oct. 15/92	
January 1993								Interim Final PIT
February 1993								
March 1993							Final determination 1991 PIT using Dec. 31/92 BFT data	Final PIT and OTC payment

Fiscal Years: 1989/90
1990/91
1991/92
1992/93

Note: For the 1989 and subsequent taxation years, payments in respect of PIT are made as follows: (1) the 6th working day; (2) the 3rd working day after the 15th calendar day; (3) the 1st working day after the 20th calendar day; (4) the 2nd last working day of the month. For each taxation year the PIT payments commence on the 3rd working day after the 15th calendar day in February of the year, and on the 6th working day of February of the following year.

APPENDIX D

**AMENDMENTS TO THE
TAX COLLECTION AGREEMENT:
A CHRONOLOGY**

Amendments to the Tax Collection Agreement: A Chronology

Year	Section	Amendment	Effects
1968	17(2)	Provinces permitted to increase tax rate if federal changes result in reduction of level of Basic Federal Tax.	Protected Ontario from lock-in restrictions of provincial revenue being derived as percentage of BFT.
1970	7(3)(a)	Minister of National Revenue empowered to estimate amount of provincial PIT for a taxation year.	Left control of forecast and economic model to federal authority. This has become progressively more problematic as annual interim and final adjustments increase.
1973	10(5)	Fines, penalties and awards from prosecutions for both federal and provincial portions of PIT amounts awarded to RCT.	Provides a pool of ancillary revenue for RCT, which can be controlled fully and exclusively by RCT decision.
	17(1)	Changes to provincial tax rates must be by multiples of 0.5% and official notification for Jan 1 st start-up is Oct 15 th of the previous year and for July 1 st start-up is Apr 15 th of same year.	Restricts Ontario flexibility to make immediate changes and by smaller percentages.

Appendix D (cont'd)

Year	Section	Amendment	Effects
1976	7(3)(b)	Change in number of instalment payments.	More frequent cash flow to Ontario.
1978	5(a)(b)	Introduction of second estimate revision by Finance Canada.	Improved cash flow to Ontario.
1989	7(3)(b)(c)	Instalment payments commence in February rather than March.	Accelerated cash flow to Ontario.

APPENDIX E

FEDERAL ACTIONS TAKEN TO INCREASE NON-TAX REVENUE

Federal Actions Taken to Increase Non-Tax Revenue

Year	Action Taken
1962 - 1977	Interest rate on overdue taxes was fixed at 6%, calculated on a simple interest basis.
1978 - 1981	Interest rate on overdue taxes adjusted yearly, ranging from 8% in 1978 to 12% in 1981.
1982	Interest rate on overdue taxes adjusted quarterly, ranging from a low of 8% to a high of 16% between 1982 and 1990. The average during this period was 11.5%.
1987	Interest rate on overdue taxes changed from simple interest computation to daily compound interest computation.
1988	<p>Effective January 1, 1989, the schedule for remittance of withholding tax by employers advanced and changed from once monthly to twice monthly for all employers with monthly withholding tax amounts of \$15,000 or more. Prior to January 1, 1989, remittances were due by the 15th day of the month following the month the deductions were withheld. Effective January 1, 1989, withholding deductions made on or before the 15th day of the month became due by the 25th day of the same month. Withholding deductions made from the 16th day of the month to the end of the month became due by the 10th day of the following month.</p> <p>This resulted in the federal government receiving three, rather than two, remittances before the first transfer of PIT to Ontario. The advanced and more frequent remittance of withholding deductions represents an interest income gain for the federal government between the period of receipt and transfer to Ontario.</p>

1989

Effective January 1, 1990, the schedule for remittance of withholding tax by employers advanced and changed from twice monthly to four times monthly for all employers with monthly remittances of \$50,000 or more. The remittance schedule was changed from the timing for employers remitting twice monthly to: on or before the third day, not including Saturdays or holidays, following the period:

1st to 7th day of the month
8th to 14th day of the month
15th to 21st day of the month
22nd to last day of the month.

Also, effective January 1, 1990, quarterly remittance filers and individual instalment payers were required to file by the 15th day of the remitting month, rather than the last day of the remitting month.

Again, earlier and more frequent receipt of tax remittances represents an interest income gain for the federal government between the period of receipt and transfer to Ontario.

APPENDIX F

REVIEW OF TAX CHANGES IN FEDERAL AND PROVINCIAL BUDGETS, 1971 - 1990

Introduction

Over the years, there have been many changes in federal and provincial tax policy that have required accommodation within the personal income tax system. Most of the significant changes have occurred since 1984, when, following the election of a new federal government, sweeping changes have been introduced through the process of federal tax reform.

Below is a year-by-year review of the most notable tax changes announced in federal and provincial budgets between 1971 and 1990, inclusive.

1971

Federal

- introduction of taxable capital gains effective Jan 1/72, employment expense deduction, child care expense deduction of \$500 per child and \$2,000 per family, moving expense deduction
- UI premiums became deductible and benefits taxable
- expansion of allowable medical expenses, deductibility of medical plan premiums, deductible charitable donations increased from 10% to 20%
- two types of income averaging introduced, substantial increases for deductibility of RRSP contributions

1972

Ontario

- introduction of property tax credit within PIT system

1973

Federal

- basic federal tax cut by 5% (min \$100, max \$500) effective Jan 1/73
- PIT indexation introduced based on CPI increases

Ontario

- sales tax credit and pensioner tax credit added to Ontario Tax Credit system via PIT system

1974

Federal

- minimum basic federal tax reduction increased to \$150 from \$100 in 1974, and basic federal tax reduction increased from 5% to 8% (min \$200, max \$700) for 1975
- first \$1,000 of interest and pension income exempt from tax
- transferable age exemptions between spouses
- cash bonuses on CSBs treated as either interest income or capital gains
- introduction of RHOSP
- taxpayer allowed to make spousal RRSP contribution

Ontario

- enrichment of property, sales and pensioner tax credits

1976

Federal

- transferability of unused disability deduction
- administrative simplification of transfers of deductions between spouses

1977

Federal

- enrichment of federal tax credit with \$50 credit per eligible dependent child

Ontario

- exemption from tax if taxable income less than \$1,680
- rate of Ontario tax increased from 30.5% to 44% of Basic Federal Tax

1978

Federal

- introduction of refundable child tax credit

1980

Federal

- increase in child tax credit from \$238 to \$261 per child

Ontario

- introduction of Ontario Pensioners Property Tax Assistance Act (OPPTA) eliminating pensioners from property, sales and pensioner credits of the Ontario Tax Credit program within the PTT system

1981

Federal (the MacEachen budget)

- elimination of tax deferrals for income-averaging annuities and capital gains reserves
- repeal of general averaging provisions
- low interest employee loans and employer-supplied vehicles become taxable
- reduction of tax deferral for investment income accrued but not received for an extended period
- end of deduction of carrying charges in excess of related investment income
- reduction of marginal tax rates with top rate reduced to 34%
- federal tax credit set at \$200 for all individuals with
- married taxpayers able to claim \$200 for a dependent spouse
- child tax credit increased from \$261 to \$293 per child

Ontario

- increase of tax rate from 44% to 48% of basic federal tax

1982

Federal

- child tax credit raised from \$293 to \$343 per child
- investments in a new form of term deposit or funds invested in purchase of common shares of Canadian corporations would not be taxed for interest/capital gains reflecting inflation increase only

1983

Federal

- elimination of standard \$100 deduction for charitable donations and medical expenses - receipted claims only
- introduction of Scientific Research and Experimental Development Tax Credit (SRTE)

Ontario

- temporary personal income tax surcharge (social services maintenance tax) for 1983 and 1984 - 2.5% of Basic Ontario Income Tax in excess of \$110.80 in 1983 and 5% in 1984

1985

Federal (first Wilson budget)

- introduction of \$500,000 lifetime capital gains exemption (\$250,000 taxable capital gains) realized by individuals after 1984 (\$10,000 taxable capital gains in 1985, \$25,000 in 1986, \$50,000 in 1987, \$100,000 in 1988, \$150,000 in 1989 and \$250,000 in 1990 and after)
- sale of farm property received full exemption immediately, with special RRSP provision for tax-free capital gains roll-over removed
- changes to net capital loss deductions from other income for losses realized after 1984 re: capital gains exemptions
- exemption from tax of first \$25,000 of interest-free housing loan over a five-year loan repayment period
- minimum income tax introduced effective Jan 1/86

- compound rather than simple interest calculated on a quarterly basis for refunds and payments
- introduction of surtax on high income individuals effective Jan 1/85
- elimination of federal tax reduction for 1986 and onwards

Ontario

- tax rate increased from 48% to 50% of basic federal tax
- surtax of 3% of Ontario income tax in excess of \$5,000 for 1986 tax year

1986

Federal

- prepayment of child tax credit
- introduction of refundable sales tax credit
- effective 1986, married exemption changed to include spouse income for entire year rather than only for period after marriage in the year
- introduction of daily rather than quarterly compounding of interest on unpaid taxes, penalties and refunds

1987

Federal

- changes to accelerate source deductions remittances
- changes to refundable sales tax credit limiting any person as a qualified relation to only one other eligible individual, and requirement that individual claiming a child must add to income the income of child's parent with whom the individual resided at year end

Ontario

- increase of property tax credit calculated as the lesser of a) \$230, or b) occupancy cost plus 10% of occupancy cost
- persons admitted to Canada as Visitors with Student Authorization permitted to claim Ontario tax credits

- Ontario tax reduction revised effective 1988 to eliminate Ontario tax otherwise payable if taxable income below \$2,483 and to reduce tax otherwise payable for taxable income between \$2,483 and \$2,747

1988

Federal

- introduction of \$200 supplement per child for child tax credit per eligible child (\$100 in 1988, \$200 after 1988)

Ontario

- tax rate increases to 51% of basic federal tax in 1988 and 52% in subsequent years
- Ontario surtax of 10% on Ontario tax exceeding \$10,000
- revisions to Ontario tax reduction program to eliminate tax otherwise payable for amounts of \$150 or less and reduce tax otherwise payable on amounts between \$150 and \$225
- revised calculation for eligibility and level of OTC benefit and Ontario Home Ownership Plan (OHOSP) tax credits become part of OTC system within PIT

1989

Federal

- introduction of repayment (claw-back) of social transfers for OAS and family allowance benefits at rate of 15% of individual net income exceeding \$50,000
- increase in individual surtax from 3% to 4% for 1989 and 5% for subsequent years and 1.5% for federal tax over \$15,000
- allowance of deductions for part-time attendant care
- refundable sales tax credit increased in 1989 from \$70 per individual and spouse and \$35 for other qualified relatives to \$100 and \$50 respectively and \$140 and \$70 respectively in 1990 with 1990 income threshold increased from \$16,000 to \$18,000

Ontario

- tax rate increased from 52% to 53% of basic federal tax
- enrichment of tax reduction program to eliminate tax otherwise payable of \$166 or less and reduce tax otherwise payable for amounts between \$166 and \$250

1990

Federal

- confirmation that timetable for changes under Pension Benefits Standards Act become operative Jan 1/91

Ontario

- enrichment of Ontario tax reduction program to include a supplement of \$200 for each dependent child under age 18 or with a disability

APPENDIX G

CALCULATION OF NON-TAX REVENUE ATTRIBUTABLE TO ONTARIO

In a memorandum and attachments dated July 9, 1991, Revenue Canada Taxation (RCT) provided some of the information requested by the Ministry of Revenue on January 18, 1991. RCT data supplied relating to penalties and interest, as well as write-offs of uncollectible debts, are contained on pages 73 and 74. These data include amounts related to corporations taxes collected under the Tax Collection Agreement (TCA). Since Ontario administers its own corporations tax, it is necessary to subtract any financial data pertaining to corporations taxes.

Also, since Quebec is the only province which is not a partner to the TCA, the ratio of Canada-wide provincial personal income tax (PIT) to the amount of Canada-wide Basic Federal Tax (BFT) must take into consideration the presence of Quebec-based BFT and the absence of Quebec-based provincial PIT.

From the data contained in the penalty and interest table on page 73, it is necessary to identify amounts relating only to personal income tax paid directly by individuals or by employers on their behalf. Using the 1989-90 fiscal year, which uses data from tax returns for the 1989 taxation year, the total amount of penalties and interest, net of refund interest, was \$1,132,083,000. Based on specific penalty and interest data provided by RCT for individuals, the national figure was calculated as follows:

Arrears Interest	\$692 million
Instalment Interest	\$192 million
Penalties	\$86 million
Sub-total	\$970 million
Less:	
Refund Interest	\$182 million
Net Total	\$788 million

With respect to write-offs of uncollectible amounts, individual and payroll write-offs for the 1989-90 fiscal year are identified in the 1991-92 Revenue Canada, Taxation Estimates, Part III. These amounts are:

Individuals	\$110 million
Payroll Deductions	\$46 million
Total	\$156 million

To establish the amounts of penalties, interest and write-offs attributable to Ontario, the following computations have been made.

1. Using taxation year 1989, the most recent, complete year for which data is available, a total of \$53.230 billion in national Basic Federal Tax was collected. For the same taxation year, a total of \$22.247 billion in net provincial personal income tax was collected via the Tax Collection Agreement. This produces a ratio of BFT to provincial PIT of 1:0.417941 (i.e. for every \$1 in BFT, approximately \$0.42 in provincial PIT was generated). Canada's portion of the total \$1.417941 in federal-provincial tax is 70.524796%, while the provincial portion is 29.475204%.
2. Of the \$22.247 billion in net Canada-wide provincial PIT collected via the TCA for taxation year 1989, Ontario's net provincial PIT was \$12.759 billion, or 57.35155% of the net Canada-wide provincial PIT collected.

The calculations below use the above percentages to calculate amounts attributable to Ontario.

**Financial Amounts Attributable to Ontario
1989-90**

Item	Penalties and Interest	Write-Offs
Total RCT amount	\$788,000,000	\$155,769,000
Total Amount Attributable to Provinces (29.475204%)	\$232,264,600	\$45,913,230
Provincial Amounts Attributable to Ontario (57.35155%)	\$133,207,340	\$26,331,950

TABLE I

**Net Collections from Individuals by Revenue Canada, Taxation
as of March 31, for the years 1974-75 to 1989-90**

Net Collections (\$000)			
Fiscal Year -----	Tax Revenue -----	Penalties & Interest -----	Total -----
1989-90	91,593,955	1,132,083	92,726,038
1988-89	82,362,499	866,932	83,229,431
1987-88	79,747,333	841,920	80,589,253
1986-87	67,536,753	603,745	68,140,498
1985-86	59,275,451	383,419	59,658,870
1984-85	52,785,674	362,278	53,147,952
1983-84	49,647,829	445,728	50,093,557
1982-83	45,725,065	538,694	46,263,759
1981-82	41,561,971	436,365	41,998,336
1980-81	33,600,194	287,940	33,888,134
1979-80	27,742,620	192,492	27,935,112
1978-79	24,764,269	190,584	24,954,853
1977-78	22,936,790	164,823	23,101,613
1976-77		Not available	22,711,351
1975-76		Not available	19,532,201
1974-75		Not available	17,436,853

Notes: - Net collections from individuals includes employer remittances and direct payments from individuals.
 - Collections are net of Refunds.
 - Penalties and interest data provided for the years prior to 1986-87 are based on calendar year.

Sources: - Reports of the Department of National Revenue for the fiscal years ended March 31, 1975 to 1990.
 - Revenue Reporting and Tax Analysis Division, RCT.

TABLE II

**Uncollectible and Bankruptcy Write-offs
for the years 1974-75 to 1989-90**

(\$000)

Fiscal Year -----	Uncollectible Write-offs -----	Bankruptcy Write-offs -----	Total -----
1989-90	767,868	59,237	827,105
1988-89	524,300	55,299	579,599
1987-88	252,563	49,212	301,775
1986-87	493,281	94,473	587,754
1985-86	174,261	91,348	265,609
1984-85	96,278	59,079	155,357
1983-84	61,585	47,772	109,357
1982-83	52,638	35,123	87,761
1981-82	31,114	34,594	65,708
1980-81	24,681	14,149	38,830
1979-80	28,607	11,310	39,917
1978-79	27,840	9,271	37,111
1977-78	23,540	7,197	30,737
1976-77	14,674	3,913	18,587
1975-76	Not available	Not available	-
1974-75	Not available	Not available	-

Source: Financial Analysis and Resource Allocation Directorate

APPENDIX H

COMPARISON OF THE PAYMENT SCHEDULE: PRE-1989 AND 1989 AND ONWARDS

Comparison of the Payment Schedule Pre-1989 and 1989 and Onwards

Pre-1989

- 48 equal payments, (4 per month), commencing in **March**, as follows:
 - i) on the 6th working day of the month;
 - ii) on the 1st working day following the 15th calendar day of the month;
 - iii) on the 2nd working day following the 15th calendar day of the month;
 - iv) on the 4th working day following the 15th calendar day of the month.

1989 Onwards

- 48 equal payments, commencing in **February** as follows:
 - a) in February of the tax year;
 - i) on the 3rd working day following the 15th calendar day;
 - ii) on the 1st working day following the 20th calendar day of the month;
 - iii) on the second last working day of the month.
 - b) March to December, inclusive, of the tax year and for January following the tax year;
 - i) on the 6th working day of the month;
 - ii) on the 3rd working day following the 15th calendar day of the month;

Pre-1989

1989 Onwards

iii) on the 4th working day following the 15th calendar day of the month;

iv) on the second last working day of the month.

c) in February following the tax year;

i) on the 6th working day of the month.

APPENDIX I

RCT AUDIT COVERAGE RATES

1979-80 TO 1989-90

Introduction

As part of its request for information from Revenue Canada, Taxation, the Ministry of Revenue asked for actual audit coverage rates, by T1 category, during the last 15 years. To protect the confidentiality of data provided, actual coverage rates have not been displayed below. Instead, using the base year of 1979/80 as 100%, the relative rates in audit coverage for all succeeding fiscal years are reflected in the table.

TABLE

**T1 Audit Coverage Rates by T1 Category
for the years 1979-80 to 1989-90**

Fiscal Year	Farmers & Fisherman %	Professionals %	Unincorporated Businesses %
1989-90	37	44	42
1988-89	50	56	37
1987-88	56	61	46
1986-87	69	61	50
1985-86	69	61	54
1984-85	81	78	58
1983-84	94	106	75
1982-83	113	106	83
1981-82	138	89	79
1980-81	144	111	88
1979-80	100	100	100

Note: - The Unincorporated Business category includes T1-Rentals.

Source: Annual Reports on Resource Utilization.

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